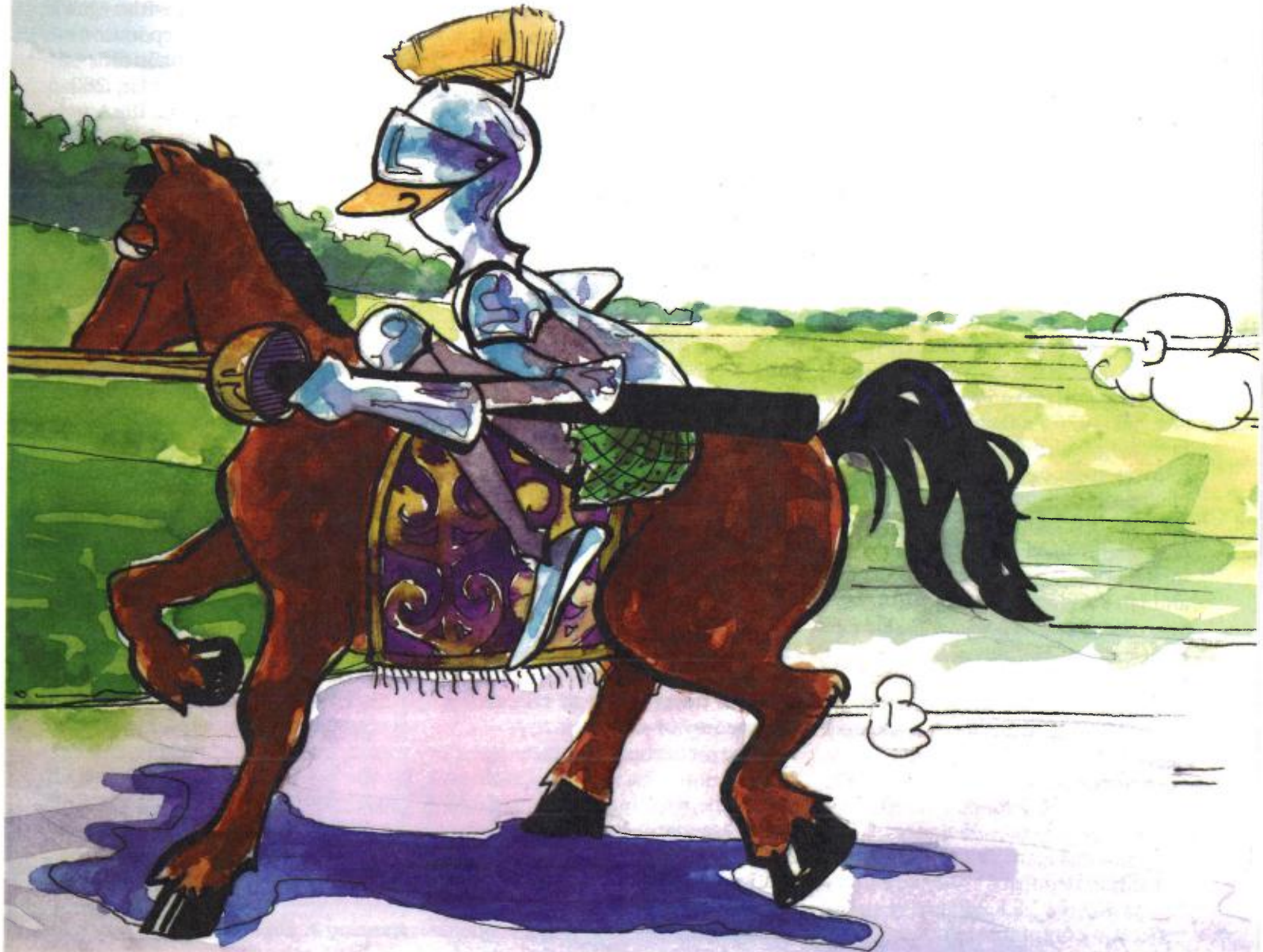
PIERCING THE CORPORATE VEIL IN SOUTH CAROLINA

By Shawn M. Flanagan

The recent case of *Hunting v. Elders*, 359 S.C. 217, 597 S.E.2d 803 (Ct. App. 2004) (certiorari granted Aug. 12, 2005; motion to dismiss granted Oct. 5, 2005), has updated the court-created doctrine of piercing the corporate veil in South Carolina by taking into account the effect of a business electing (1) to be a statutory close corporation under state law and (2) a Subchapter S corporation under tax law. *Hunting* is the first South Carolina case to apply the veil piercing doctrine to a subchapter S, statutory close corporation.



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South Carolina provides by statute that an owner of a corporation or limited liability company is not personally liable for the acts or debts of the corporation or LLC. S.C. CODE ANN. § 33-6-220 and § 33-44-303. "Piercing the corporate veil is a common law doctrine by which courts disregard the separate corporate entity in particular circumstances and impose liability on the participants behind the entity's veil." Robert B. Thompson, *Piercing The Veil Within Corporate Groups: Corporate Shareholders As Mere Investors*, 13 Conn. J. Int'l L. 379, 383 (Spring 1999). The aim of this article is to make the application of the doctrine more understandable and to encourage business lawyers to provide their clients with guidance on how to avoid its application.

Please note that this article has been abridged for publication in *South Carolina Lawyer*. The original full-length version of the article can be found at buistmoore.com and scbar.org.

Development of the doctrine in South Carolina

The modern South Carolina test was first applied 30 years ago in *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976), a federal case involving South Carolina law. The test was approved by the S.C. Court of Appeals in *Sturkie v. Sifly*, 280 S.C. 453, 313 S.E.2d 316 (Ct. App. 1984) (although the court forgot to include one factor in its decision), and later endorsed by the S.C. Supreme Court in *Multimedia Publ'g of S.C., Inc. v. Mullins*, 314 S.C. 551, 431 S.E.2d 569 (1993).

"'[P]iercing the corporate veil' is not a doctrine to be applied without substantial reflection." *Baker v. Equitable Leasing Corp.*, 275 S.C. 359, 367, 271 S.E.2d 596, 600 (1980). There is a "general reluctance of courts to disregard the integrity of the corporate entity." *Sturkie*, 280 S.C. at 459, 313 S.E.2d at 319. "In general, a corporation and a shareholder are separate and distinct, and the debts of the corporation are not the debts of the shareholder. However, when the corporate veil is pierced, the corporation and the individual become one and the same." *See DeWitt*, 540 F.2d at 683. "As they are identical, the liabilities of the corporation are the liabilities of the shareholder." *Hunting*, 359 S.C. at 230, 597 S.E.2d at 809-810.

General description of the first prong of the test

State courts, as well as federal courts, in South Carolina use a **two-prong test** to determine whether a corporate entity should be disregarded. "The first prong is an eight factor analysis of the shareholder's relationship to the corporation." *Multimedia Publ'g of S.C., Inc.*, 314 S.C. at 553, 431 S.E.2d at 571. It is "designed to analyze the corporation's adherence to the corporate form." *Univ. Med. Assocs. of Med. Univ. of S.C. v. UnumProvident Corp.*, 335 F. Supp. 2d 702, 707 (D.S.C. 2004). It "looks to observance of the corporate formalities by the dominant shareholders." *Sturkie*, 280 S.C. at 457, 313 S.E.2d at 318.

The conclusion to disregard the corporate entity must involve a number of the eight factors, but need not involve them all. *Dumas v. InfoSafe Corp.*, 320 S.C. 188, 192, 463 S.E.2d 641, 644 (Ct. App. 1995). "Neither *Sturkie* nor any other case cited by the parties has set forth the weight that must be accorded to each of the eight factors, nor has any case required that each factor be accorded equal weight with the others." *Hunting*, 359 S.C. at 225, 597 S.E.2d at 807. The eight factors will be discussed separately and later in this article in the context of the *Hunting* case.

General description of the second prong of the test

The second prong of the test "need not be reached until and unless the requirements of the first prong are met." *Hunting*, 359 S.C. at 225, 597 S.E.2d at 807. The second prong requires "that there be an element of injustice or fundamental unfairness if the acts of the corporation be not regarded as the acts of the individuals" and "is perhaps more elusive." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 809. "The corporate form may be disregarded only where equity requires the action to assist a third party." *Woodside v. Woodside*, 290 S.C. 366, 370, 350 S.E.2d 407, 410 (Ct. App. 1986). "[F]undamental unfairness can exist in the absence of fraud ... [and] may be proved by a lesser showing than the defendant's reckless disregard for whether claims against the corporation exist." *Multimedia Publ'g of S.C., Inc.*, 314 S.C. at 554, 431 S.E.2d at 572.

"The burden of proving fundamental unfairness requires that the plaintiff establish (1) that the defendant was aware of the plaintiff's claim against the corporation, and (2) thereafter, the defendant acted in a self-serving manner with regard to the property of the corporation and in disregard of the plaintiff's claim in the property." *Sturkie*, 280 S.C. at 459, 313 S.E.2d at 319. A person is "aware" of a claim against the corporation "if he has notice of facts which, if pursued with due diligence, would lead to knowledge of the claim." *Multimedia Publ'g of S.C., Inc.*, 314 S.C. at 555, 431 S.E.2d at 572. "The essence of the fairness test is simply that an individual businessman cannot be allowed to hide from the normal consequences of carefree entrepreneuring by doing so through a corporate shell." *Multimedia Publ'g of S.C., Inc.*, 314 S.C. at 556, 431 S.E.2d at 573.

"Piercing the corporate veil" will not occur if the "fundamental unfairness" standard of the second prong can be avoided, which is what occurred in the *Sturkie* case. The appeals court in *Sturkie* affirmed the trial court based on the fact that the record was "totally devoid of any evidence from which we can determine that the respondents were aware of the claim presented by the receiver at the time they engaged in the acts relied on by the receiver to establish personal liability." *Sturkie*, 280 S.C. at 459, 313 S.E.2d at 319.

Hunting v. Elders

In *Hunting*, April 2, 1994, Catherine L. Hitchcock was injured in an accident caused by a drunk

driver. In January 1995, Hitchcock's guardian *ad Litem* brought suit against (1) Chris Gordon (Gordon) as the drunk driver, (2) Elmyer Enterprises, Inc. (Elmyer Enterprises) as the owner and operator of a bar named Willie's and (3) William Elders (Elders) as the alter ego of the corporation. In the first phase of the trial, actual damages of $1.5 million were awarded against Gordon and Elmyer Enterprises in September 1997. The second phase of the trial resulted in a holding in June 2001 that Elders was the alter ego of Elmyer Enterprises, justifying "piercing the corporate veil." Elders appealed, but the S.C. Court of Appeals affirmed the trial court. *Hunting*, 359 S.C. at 220-221, 597 S.E.2d at 805. (The author's law firm was involved in the first phase of the trial of this case. This is an academic paper, and the facts set forth above are taken from the order and opinions in the case. They are in no way representative of the positions of any of the parties.)

On June 22, 1993, Elmyer Enterprises elected to be a South Carolina statutory close corporation pursuant to Chapter 18 of the South Carolina Business Corporation Act of 1988 (the Act). Elmyer Enterprises was also apparently a Subchapter S corporation for state and federal income tax purposes.

A South Carolina statutory close corporation is allowed to organize and operate less formally than "the classical model of a corporation." An encouraging statute for business lawyers, S.C. CODE ANN. § 33-18-250 provides that the failure of a statutory close corporation to observe the usual corporate formalities is not a ground for imposing personal liability on the shareholders. The following statement in the Official Comment suggests, however, that the statute may not mean quite what it says: "This section does not prevent a court from 'piercing the corporate veil' of a statutory close corporation if the circumstances should justify imposing personal liability on the shareholders were the corporation not a statutory close corporation. It merely prevents a court from 'piercing the corporate veil' ***because*** it is a statutory close corporation." (Emphasis added.) The Official Comment indicates that the purpose of Section 33-18-250 is to provide explicitly that a corporation will not have its corporate veil pierced ***merely because*** it organizes and operates in accordance with the Statutory Close Corporation Supplement of the Act.

The Court of Appeals was sensitive to the distinction between traditional corporations and statutory close corporations.

> The ability under state corporate law to adopt and operate under a statutory close corporation status has, as a practical matter, diminished the importance of several of the eight factors. In the same fashion, the ability of corporations to avoid double taxation by adopting S corporation status under federal income tax law has lessened the importance of applying the factor concerning the nonpayment of dividend. ... The *Sturkie* factors which now have less importance include the failure to observe corporate formalities, nonfunctioning of other officers or other directors, the absence of corporate records and, as stated above, the nonpayment of dividends.

Hunting, 359 S.C. at 225-226, 597 S.E.2d at 807.

It is instructive to review each factor separately, but keep in mind that the factors can overlap and blur into each other at times. It should be noted that the South Carolina cases reviewed generally do not tick off each factor in turn and separately as this article does below.

(1) **Whether the corporation was grossly undercapitalized for the purposes of the corporate undertaking**. One of the most important factors considered by South Carolina courts is gross undercapitalization. "One fact which all the authorities consider significant in the inquiry, and particularly so in the case of the one-man or closely-held corporation, is whether the corporation was grossly undercapitalized for the purposes of the corporate undertaking. And, '(t)he obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter ... during the corporation's operations.'" *DeWitt*, 540 F.2d at 685-686 [citations omitted].

In *Hunting*, the court held that Elmyer Enterprises failed to remain properly capitalized as an ongoing business. It was initially funded with $2,000, which "was minimal at best." *Hunting*, 359 S.C. at 227, 597 S.E.2d at 808. The court found that the corporation appeared to have sufficient cash flow to experience growth; however, "no evidence was produced showing that that growth was ever reflected in the corporation's capital account." *Id.* The amount of capital deemed sufficient will vary from business to business. The court stated that "a corporation established for the purpose of serving alcohol has more inherent risks and should be adequately protected from liability associated with those risks. The failure to properly protect the business and others should be considered when determining whether the corporation is properly capitalized." *Id.* at 227-228.

Procuring insurance in an amount and coverage that is reasonable for a client's industry should be sufficient to "protect the business and others." The factor would arguably not have been present if Elmyer Enterprises had, for example, $1,000,000 of dram shop coverage (which it did not) even though the $1,500,000 judgment would have exceeded such coverage.

(2) **Failure to observe corporate formalities**. The appeals court interpreted S.C. CODE ANN. § 33-18-250 in light of the Official Comment to that statute and, as a result, a statutory close corporation cannot completely ignore corporate formalities with immunity. The same result is likely for a limited liability company since Section 33-44-303(b) of the LLC Act contains the same language as appears in Section 33-18-250 of the corporate Act. According to the trial court's order dated June 20, 2001, Mr. Elders produced corporate minutes

of "numerous shareholder meetings" but "no credible evidence was presented that would support a finding that the shareholder meetings ... ever took place." According to the Court of Appeals, "Elders maintained a bare minimum of corporate records." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808.

"While disregard of corporate formalities is a circumstance to be considered, it is generally held to be insufficient in itself, without some other facts, to support a piercing." *DeWitt*, 540 F.2d at 686, n.14. "[T]he failure to adhere to these formalities alone cannot be used to pierce the corporate veil." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808.

As a matter of law, the court in *Hunting* held that the "failure to observe corporate formalities" is less important in the case of a statutory close corporation. Therefore, the factor is not irrelevant, but it is less important. *Hunting*, 359 S.C. at 225-226, 597 S.E.2d at 807. "Admittedly, Elmyer Enterprises was not required to follow the same corporate formalities as a regular business corporation." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808. The Court did not focus much attention on whether this factor was present. Such focus was not necessary since the Court found the presence of four to five other factors, which is a sufficient number to pass the first prong of the test.

(3) **Non-payment of dividends**. A closely-held C corporation prefers to distribute a majority (if not all) of its profits to its shareholders as compensation (wages, salary and bonuses) to obtain a deduction for income tax purposes. (Since a C corporation cannot deduct dividends paid to its shareholders, a closely-held C corporation might not ever pay a dividend.) In contrast, after paying its employees reasonable compensation for services rendered, a closely-held S corporation prefers to pay out a portion of its profit to its shareholders as dividends to minimize Social Security and Medicare taxes. Similar to a partnership, an S corporation is a "pass through" vehicle for tax purposes. In other words, an S corporation pays no income tax at the corporate level. The court agreed with the defendant that the failure of Elmyer Enterprises to pay dividends would not be held against Elders, but also pointed out that the payment or nonpayment of dividends is not as important as the other factors in an analysis involving an S corporation. *Hunting*, 359 S.C. at 227-228, 597 S.E.2d at 808. For guidance from another jurisdiction, see *Trustees of the Nat'l Elevator Indus. Pension v. Lutyk*, 140 F. Supp. 2d 447, 459 (E.D.Pa. 2001), aff'd, 332 F.3d 188, 196 (3rd Cir. 2003).

(4) **Insolvency of the debtor corporation at the time**. "Even though the corporation was able to pay its debts and thereby escape the classical definition of insolvency, the evidence indicates that Elders left in the till only so much as was necessary to pay basic expenses." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 809. S.C. CODE ANN. § 33-6-400(c) provides, in general, that no distribution may be made to shareholders if, after giving it effect, the corporation would be insolvent. The analogous statute for limited liability companies is S.C. Code Ann. § 33-44-406. The Official Comment to S.C. Code § 33-6-400 states that S.C. Code § 33-1-400(7) "defines 'distribution' to include virtually all transfers of money, indebtedness of the corporation or other property to a shareholder in respect of the corporation's shares." (Emphasis added.) Compensation for services rendered (wages, salary and bonuses) is not included in the definition of "distribution."

(5) **Siphoning of funds of the corporation by the dominant stockholder**. This factor is perhaps the most dangerous since it not only counts towards the first prong of the test, but it can also result in a finding of "injustice or fundamental unfairness." "The factors dealing with undercapitalization, siphoning of funds, and whether the corporation was a facade for its dominant shareholder are closely related." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 808. The South Carolina cases reviewed do

not specifically define what is meant by "siphoning of funds." In *C.T. Lowndes & Co. v. Suburban Gas & Appliance Co., Inc.*, 307 S.C. 394, 415 S.E.2d 404 (Ct.App. 1991), the court stated that McLaughlin "siphoned the net proceeds [from the sale of Suburban's assets] out of Suburban for his own benefit and for the benefit of Southside [McLaughlin's wholly owned corporation]" rather than pay an insurance agent of Suburban. *Id.* at 396.

Is "siphoning of funds" the distribution of money to or for the benefit of a dominant shareholder at any time when there is an unpaid expense or legal debt outstanding? A narrower and more accurate description may be that siphoning of funds occurs when there are insufficient funds to pay **all** currently known and due claims and the dominant shareholder (knowing there are insufficient funds) prefers himself over some creditor. For purposes of this article, the definition of a "currently due claim" includes debt service in any given month, but excludes the remainder of the outstanding debt until the maturity date of the loan or its acceleration in the event of a default.

Case law indicates that one way to satisfy the second prong of the test (i.e., the "injustice or fundamental unfairness" standard) is if the "siphoned funds" can be associated directly with the unpaid debt. This association between the "siphoned funds" and the unpaid debt is easily made in the *DeWitt* (4th Cir. 1976), *Cumberland Woods Products* (S.C. Ct. App. 1992) and *Dumas* (S.C. Ct. App. 1995) cases. The reader should refer to the full-length version of this article found at buistmoore.com and scbar.org to review facts in these three cases indicating the presence of the second prong and guidance on this factor from four out-of-state cases.

In *Hunting*, the focus was primarily on income derived from video poker machines located in the bar. The "Findings of Fact" in the trial court's order was 11 pages long, about six pages of which discussed the corporation's revenue. "The trial court found Elders siphoned substantial funds from the corporation, and the evidence substantiates this finding. Using documents from the corporation, the forensic accountant testified there was a significant amount of income not reported, and she determined that Elders siphoned $400,000 to $800,000 from Elmyer Enterprises over a three-year period." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 808-809.

Corporate profit (if any) is usually paid or distributed to the owner of a close corporation unless needed in the business for some necessary or advisable expenditure (for example, to pay for building renovations or to purchase equipment, materials or inventory). The only statutory limitation is that the corporation is supposed to pay its bills first and remain solvent. As noted, whether the money received by the owner is characterized as "compensation" or as a "dividend" may be based on the most favorable result from a tax point of view.

The court found that Elders left enough in the till to pay basic expenses. This is probably how the large majority of small closely held corporations operate. Is there something inherently wrong with the practice? The *Hunting* court seemed to hang its hat on unreported income. But why is this "siphoning?" Would not the owner have been entitled to this income even if it had been reported on the corporation's tax return? This was more of an issue for the IRS and S.C. Department of Revenue (the tax authorities) than for the plaintiff. Yet, the court appeared satisfied that the owner's receipt of income "off the books" was the equivalent of "siphoning," even though it may have had no practical effect on the corporation's available funds.

(6) **Non-functioning of other officers or other directors**. Elmyer Enterprises elected to operate without a board of directors. Elders designated his wife as vice president and his niece as secretary and treasurer of the corporation. However, the niece knew nothing about her selection as an officer. *Hunting*, 359 S.C. at 222, 597 S.E.2d at 805. Elders produced minutes indicating that his wife and niece were present during meetings. However, the niece testified she never attended any corporate meetings. *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808.

(7) **Absence of corporate records**. Maintaining records is (or at least should be) a normal activity for all businesses. Records must be maintained for purposes of a business license. S.C. CODE ANN. § 33-16-200 provides that a corporation shall furnish an annual financial statement to each of its shareholders. Corporations and partnerships must file tax returns (even if they have no revenue), which are signed under penalty of perjury. Records should be maintained for a minimum of three years to deal with potential tax audits. Although status as a statutory close corporation may lessen the importance of the "corporate records factor," it does not eliminate it. "Although Elders maintained a bare minimum of corporate records, normal business records were definitely lacking in sufficiency." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808.

(8) **The fact the corporation was merely a facade for the operations of the dominant stockholder**. Mr. Elders owned 99 percent of the stock of Elmyer Enterprises, and the trial court found that the evidence "established that Elders controlled all aspects of the business." "The trial court found Elders lacked credibility in his explanation for the difference in the income and what was reported. The court specifically found the money was never accounted for and must have been siphoned by Elders. This is additional evidence that the corporation was used as a mere facade for the benefit of the dominant shareholder, justifying the ultimate conclusion reached by the trial court." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 809.

Facts indicating the presence of the second prong

In addition to meeting the first prong of the test, the court in *Hunting* held that the second prong

was satisfied. The fact that a shareholder knows about a claim and thereafter moves assets out of the debtor corporation indicates the possible presence of the second prong of the *DeWitt/Sturkie* test. "There is evidence that indicates Elders knew of the plaintiff's claim against the corporation and that, as the trial court found, he nevertheless acted in a self-serving and unfair manner by siphoning off substantial sums of money, commingling and transferring assets which he held in his own name to different entities, transferring stock in the corporation to other individuals without a valuable consideration, and then finally dissolving the corporation." *Hunting*, 359 S.C. at 229, 597 S.E.2d at 809.

According to the author's research, eight of the nine reported state court decisions in South Carolina applying the *DeWitt* test pierced the corporate veil (the sole exception being *Sturkie)*. The limited liability shield therefore failed in almost 89 percent of the reported cases. In one empirical study performed nationwide, it was found that courts pierced the corporate veil in approximately 40 percent of all reported cases. Thompson, *supra*, 13 Conn. J. Int'l L. at 384. This would seem to indicate that state courts in South Carolina are more likely to rule in favor of veil piercing than courts in other states.

Piercing the veil can be avoided if the second prong is not present. Reviewing some of the facts of the case law provides guidance on how to avoid the second prong. The original full-length version of this article found at buistmoore.com and scbar.org details the facts of seven cases where the second prong of the test was met and the court allowed the corporate veil to be pierced. The facts were selected by the author from each case for the sole purpose of illustrating the second prong of the test.

Parent-subsidiary corporations, reverse-piercing and brother-sister corporations

Even the smallest client may have more than one business entity. For a discussion of veil piercing in South Carolina in the context of parent-subsidiary corporations, reverse-piercing and brother-sister corporations, the reader should refer to the original full-length version of this article found at buistmoore.com and scbar.org.

Summarizing the *Hunting* case

The S.C. Court of Appeals in *Hunting* pierced the corporate veil of Elmyer Enterprises. The court observed that undercapitalization (factor 1), siphoning of funds (factor 5) and the corporation as a facade for the operations of the dominant shareholder (factor 8) are closely related. In addition to the presence of these three factors, the court found the presence of two other factors, for a total of five out of eight: "Admittedly, Elmyer Enterprises was not required to follow the same corporate formalities as a regular business corporation. Although the failure to adhere to these formalities alone cannot be used to pierce the corporate veil, coupling the dearth of corporate business records [factor 7] and the inactivity of other corporate officers [factor 6] with the evidence of substantial siphoning of funds [factor 5] provides evidence upon which the trial court, at least in part, based its decision." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808. In the second prong of the test, the court found that injustice or fundamental unfairness would result if Elders were not held personally responsible based primarily on the finding that he siphoned off "substantial sums of money." *Id.* at 229.

It is fair to ask what Elders should have done differently, besides reporting all income. What should any small business do when threatened with a massive tort judgment? Mr. Elders did not think the corporation was liable. Whether the drunk driver had ever been to Willie's Bar on the evening in question was hotly disputed in the first phase of the trial. Should he have "saved up" corporate funds in anticipation of a judgment? Must a small business quit paying its owner anything (even a reasonable salary for services rendered) and put all of its income in escrow whenever threatened with a tort judgment? What incentive would a owner have to continue working in the business if the answer to this question is "yes?" Such a requirement would have serious financial consequences and should not be imposed without some deliberation.

If the *Hunting* case does stand for such an extreme proposition, an extreme counter measure would also be in order. What if Elders had simply "froze" the corporation once the complaint was filed? He could have closed the bar, sold the real estate (which he owned outside of Elmyer Enterprises), bought new land somewhere else and formed a new corporation to operate a new bar at the new location. Under these circumstances, the plaintiff's recovery should be limited to the assets owned by Elmyer Enterprises at the time it was frozen. The corporation might have been undercapitalized in the eyes of the court, but Elders would have stood a better chance of surviving a veil piercing challenge given the absence of the "siphoning of funds" factor.

If there is any ready answer to the *Hunting* case, it is that the corporation should have purchased dram shop insurance coverage. Such coverage, in a reasonable amount for the bar industry, would probably have forestalled any further inquiry into the corporation's capitalization and finances. At least it should have forestalled any further inquiry.

Conclusion—advice for business lawyers

"The concept of distinct corporate entity has long served useful business purposes, [which includes] encouraging risktaking by individual investors ..." *Valley Fin., Inc. v. United States*, 629 F.2d 162, 171 (D.C.Cir. 1980), cert. denied, 451 U.S. 1018 (1981). When an entrepreneur forms a new legal entity, one of his or her principal goals is obtaining limited liability for the owners of the business venture. The judicially created doctrine of "piercing the corporate veil" is probably unknown to most small business

owners. Owners oftentimes end up with Articles filed with the Secretary of State and little else. It is not unusual for a business organized years ago to have a pre-packaged corporate kit with incomplete and unexecuted fill-in-the-blank forms inside the minute book. "The granting of a charter by the State does not create a corporation. It is merely permissive." *Parker Peanut Co. v. Felder*, 200 S.C. 203, 221-222, 20 S.E.2d 716, 723 (1942).

There are more limited liability companies being formed today than corporations. The two-prong test for piercing a corporate veil will presumably be applied to limited liability companies. In that eventual analysis, a limited liability company should enjoy the same status as a statutory close corporation given their similarities. The Comment to Section 33-44-408 of the LLC Act, for example, states: "Recognizing the informality of many limited liability companies, subsection (a) does not require a company to maintain any records."

Business owners should consider taking several steps. Adopting and operating as a statutory close corporation status or a limited liability company will diminish the importance of failure to observe corporate formalities, non-functioning of other officers or other directors and the absence of corporate records (factors that appear to be closely related). *Hunting* specifically states that undercapitalization, siphoning of funds and whether the corporation is a facade for its dominant shareholder are closely related. To counter these factors and stave off application of the second prong of the test, business owners should maintain adequate insurance and reserves based on their industry. Put another way, a close corporation with adequate funds on hand to pay its regular operating expenses, including the cost of insurance against tort liabilities it can reasonably anticipate, should be properly capitalized. The business may be a member of an association that has guidelines or studies as to what working capital or reserves are normal for its industry. Adopting S corporation tax status or partnership tax status will lessen the importance of making or failing to make dividends or distributions. Most small newly formed close corporations elect to be S corporations, but probably a significantly lesser number elect statutory close corporation status.

In addition to seeing that it is properly formed, business lawyers should consider providing guidance to their clients on the application of the veil piercing doctrine. Lawyers may want to develop a standard letter with recommendations. For example: "you must respect the separate legal existence of your corporation if you expect a court to do likewise"; "do not commingle corporate funds with those of other legal entities or that of a shareholder"; "maintain adequate insurance and a reasonable amount of capital in the business based on your industry"; "do not pay any personal bills of a shareholder out of the corporate bank account"; "maintain adequate business records including records of income, expenses, sales, inventory and profit and loss statements"; "prepare minutes of meetings or owner consents to document major decisions such as electing officers, declaring dividends, taking out a loan and buying real estate"; and "in the event a lawsuit or major claim arises, cease distributing money to yourself or for your benefit in any form (including salary) until you have consulted with this office."

If a business owner is looking for some "rule of thumb" advice, it would be to (1) operate the business in a limited liability vehicle, keeping personal matters of the owner's separate; (2) contribute and maintain an adequate amount of working capital; and (3) buy substantial insurance. Advise the client to put some capital at risk, rather than put everything he or she owns at risk by opening the door to a pierce the veil argument.

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